Alaska Oil and Gas Association

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26 August 2013

The Honorable Angela Rodell, Acting Commissioner
Mr. Bruce Tangeman, Deputy Commissioner – Tax
STATE OF ALASKA, DEPARTMENT OF REVENUE
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STATE OF ALASKA, DEPARTMENT OF REVENUE
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Re: AOGA Comments on Proposed Regulations for Chapter 10, SLA 2013 ("SB 21")
Amending the Oil and Gas Production Tax, AS 43.55

Dear Commissioner Rodell and Other Department of Revenue Officials:

The Alaska Oil and Gas Association ("AOGA") appreciates the opportunity to convey our comments and suggestions on the currently proposed regulations to implement SB 21.

When Governor Parnell introduced SB 21, he outlined four key principles for Alaska's tax policy. The policy needs to be: 1) fair to Alaskans, 2) encourage new oil production, 3) be simple and restore balance, and 4) be durable for the long-term. AOGA endorses and supports these principles and SB 21 is significant and crucial tax reform for the future of our state.

We applaud the Department for proposing this draft so quickly following the passage of SB 21 with the apparent goal of having the regulations in place by January 1, 2014. The regulations as currently drafted do not further the policies and goals that the Legislature had when it enacted HCS CSSB 21(FIN) am H and those expressed by Governor Parnell when he signed it into law.

This letter outlines the most significant issues, while Enclosure A (which by this reference is incorporated as an integral part of these comments) sets out material issues and technical matters.

SB 21 has changed the focus of the State's production tax policies — shifting from encouraging greater North Slope oil production *indirectly* through incentives for making new capital investments on the Slope, and towards encouraging more production through incentives tied *directly* to the actual volume of oil being produced. As you know, the primary new incentives are, first, a combination of a $5 per barrel tax credit and a 20% gross value reduction (30% for acreage entirely subject to royalty greater than 12.5%) for what we call "new" production, and second, a stair stepped per barrel tax credit for "legacy" production where the amount of the credit per barrel depends on the monthly "gross value at the point of production" ("GVPP") per barrel. Significantly, SB 21 also terminates the "progressivity" tax at the end of this year, we will not elaborate on the benefits of that in these comments since there is little about the sunset of progressivity for the proposed regulations to address.

<u>Incentives for "new" production</u>. Proposed 15 AAC 55.211 – 15 AAC 55.213 (pages 8 – 24 of the Department's PDF version of the proposed regulations) offer complex standards and methodologies for identifying the acreage from which "new" production is produced, for ensuring that only "drainage" from that acreage will receive the "gross value reduction" ("GVR") and the $5/barrel tax credit, and for metering the exact volume of that "drainage" production. The proposed procedures and methodologies are difficult to understand and apply. In some cases the procedures are not feasible or possible to comply with.

The Department of Natural Resources ("DNR") and the Alaska Oil and Gas Conservation Commission ("AOGCC") — already have both the means and the duty to ensure proper allocation of production to the reservoir and acreage from which it was drained. DNR's interest in such matters is to have the State receive the full royalty it is entitled to, by ensuring that the correct volume of production is allocated to the proper leases. The AOGCC is vested with the State's sovereign Police Power to prevent waste and protect correlative rights, and the key for it to do that is to have proper and accurate reporting of the volumes of oil, gas, water and other substances recovered from the respective fields and reservoirs, and this power extends to federal and private lands. To reduce complexity and keep the implementation of the tax simple, we encourage the Department to piggyback off DNR's and the AOGCC's work and use the allocation factors and measurement methods that those two agencies allow producers to use in allocating production among leases in a field, participating area or unit rather than creating another system for measuring and allocating oil production as the proposed regulations would do.

If the Department does not build off these other agencies' work, then the regulations should clearly allow producers who do not find value in the onerous process and expense to comply with the rules for "new" production to opt instead to treat that oil or gas as "legacy" production. But the proposed regulations seem to say that, if production *could* qualify as "new", then it must meet the full requirements for "new" ness to get *any* SB 21 incentive, either as "new" or "legacy" production.

The stair stepped per barrel credit for "legacy" production based on monthly GVPP per barrel.

For the tax to be durable for the long-term, the tax needs to be consistent and predictable. The current draft creates uncertainty and unpredictability in that currently, a regulated pipeline tariff that a producer actually pays to an affiliated pipeline company to transport its oil or gas can be set aside in favor of a lower one to be determined by the Department. There is no deadline for the Department to make that determination, except that any claim based on it must be made within the 6-year statute of limitations under AS 43.55.075(a).

This approach towards regulated pipeline tariffs is not appropriate in the context of the stair stepped per barrel tax credit under AS 43.55.024(j). A producer could be uncertain for up to six years about how much its tax credit is. Suppose, for instance, the tariff a producer actually pays results in a GVPP per barrel of, for example, $89.75 which falls into the $80 - $90 stair step with a $7.00 a barrel credit under (j)(2). Now suppose that the pipeline cost that is eventually calculated under 15 AAC 55.197 turns out to be 50¢ less than the tariff that the producer actually paid. This raises the GVPP per barrel by 50¢, to $90.25. And for GVPP per barrel in the $90 - $100 stair step in (j)(3), the tax credit is only $6.00 a barrel. This creates uncertainty for taxpayers in complying with the tax when they report and pay the tax a month after producing the oil and gas. It also creates risk for them afterward on audit.

The Department can adopt a regulation to implement its authority in AS 43.55.150(b) to "determine the reasonable costs of transportation, using ... other reasonable methods" for the limited purpose of determining the applicable amount of the tax credits under AS 43.55.024(j)(1) – (9). If these tax credits are to have influence on production decisions, that regulation must let stand the tariff actually paid for purposes of calculating the monthly GVPP from which the amount of the stair-stepped per barrel credit is determined, since that tariff is the only one that is known or knowable when the producer has to report its monthly section 024(j) credit at the end of the month after the one when the oil and gas is produced.

This issue was raised during the Department's June 5th public workshop, and it was pointed out then that a specific new regulation would be necessary because 15 AAC 55.193(b)(5) and 15 AAC 55.197 are directed towards an entirely different tax concern. We encourage the Department to propose such a regulation.

Conclusion. In closing, we would like to remind you that AOGA is the professional trade association whose 15 member companies — Alyeska Pipeline Service Company, Apache Corporation, BP Exploration (Alaska) Inc., Chevron, eni petroleum, ExxonMobil Production Company, Flint Hills Resources, Alaska, Hilcorp Alaska, LLC, Petro Star Inc., Pioneer Natural Resources Alaska, Inc., Repsol, Shell Exploration & Production Company, Statoil, Tesoro Alaska Company, and XTO Energy, Inc. — account for the majority of the oil and gas exploration, development, production, transportation and refining of oil and gas onshore and offshore in Alaska. These comments (including Enclosure A) have been reviewed by all members and approved unanimously.

SB 21 represents a bold and significant step toward a strong and vibrant future for Alaskans. To secure that future, the regulations to implement SB 21 need to facilitate the fulfillment of that future. We encourage the Department to consider our recommended changes to fully achieve the benefits SB 21 provides to Alaska.

Thank you again for both the opportunity to share our views and concerns with you, and for your time and thoughtfulness in considering them.

Very truly yours,

ALASKA OIL AND GAS ASSOCIATION

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Enclosure

cc: Heather Brakes, Office of the Governor

Alaska Oil and Gas Association

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ENCLOSURE A

TECHNICAL COMMENTS REGARDING THE PROPOSED

REGULATIONS TO IIMPLEMENT CHAPTER 10, SLA 2013 (“SB 21”)

26 August 2013

Although we describe the comments in this Enclosure A as technical, a number of them are not purely technical, but address matters of material substance that we chose not to put in our letter, which focuses only on our most significant concerns. We appreciate your consideration of all our comments.

PART 1. SUBSTANTIVE CONCERNS

Incentives for "new" production — proposed 15 AAC 55.211, 15 AAC 55.212 and 15 AAC 55.213 generally (pp. 8 – 24[1]). As stated in the letter of which this Enclosure A is a part, the Department is proposing requirements, conditions and standards for "new" production subject to AS 43.55.160(f) and (g) that are impossible or not practicable to meet, that the Department lacks the necessary professional expertise and experience either to establish or enforce, and that have already been addressed in requirements, conditions and standards established and enforced by DNR and the AOGCC.

A. *15 AAC 55.211(c)(2) — Exclusion of state net profit share interests from determining eligibility under AS 43.55.160(g).*

The proposed last sentence of 15 AAC 55.211(c)(2) says, "For purposes of AS 43.55.160(g)" — which provides for an additional 10 percent reduction in gross value for leases that are all subject to a royalty greater than 12.5 percent — "a royalty share does not include a share of the net profit derived from a lease." We are concerned that this may contradict testimony for the Administration given by Deputy DNR Commissioner Joe Balash to the House Finance Committee on 11 April 2013, who said:

> In the case of Oooguruk because they have a royalty modification that is currently in effect they will stay at the 20 percent [reduction in gross value,] but once they reach payout in their NPSLs [i.e., Net Profit Share Leases,] then their royalty rates go back up. Then the next calendar year they will qualify for the 30 percent GRE [under as 43.55.160(g)].

Furthermore, in another context where a narrow interpretation of "royalty" could have been used – namely, for purposes of the exclusion of "royalty paid to an unrelated party" from the extraction factor under 15 AAC 20.500(c) for the oil and gas -- the Department specifically included "net profit share" in the definition of royalty. *See* 15 AAC 20.900(c)(6), which provides in pertinent part:

> For purposes of ... 15 AAC 20.410 – 15 AAC 20.530,
> ...
> (6) "royalty interest" means a basic royalty, overriding royalty, production payment (excluding loan repayment), net profit interest, or carried interest, in the production of oil or gas[.] [emphasis added]

The precedent, we believe, has therefore been set by the Department, and accordingly it should replace "does not include" with "includes" in the last sentence of paragraph 211(c)(2).

[1] All references herein to page numbers are to the respective pages in the PDF version of the 46-page set of proposed regulations that was attached to the emailed notice dated 19 July 2013 from the Department.

B. *15 AAC 55.211(e) — Possible unconstitutionality of limiting the additional 10% gross value reduction ("GVR") under AS 43.55.160(g) to state land.*

For production to be eligible at all for the additional 10% GVR under AS 43.55.160(g), proposed 15 AAC 55.211(e) would require that the production be "produced from a unit made up solely of oil and gas leases or gas only leases on state land issued by the Department of Natural Resources." We read the phrase that begins with "on state land" as applying to "oil and gas leases" as well as "gas only leases". If this reading is correct, then subsection 211(a) categorically excludes any unit consisting of high royalty leases and properties on federal lands, or on Native regional corporation lands, from the additional 10% GVR. We see no basis for the Department to make such an exclusion, and we are unsure that such discrimination — particularly against Native interests — could withstand constitutional scrutiny. Even if the Department reads AS 43.55.160(g) as implying such discrimination, nevertheless it should, if possible and reasonable, interpret and apply the statute through these regulations so that it is constitutional.

If, on the other hand, the phrase beginning with "on state land" is intended to clarify the undefined term "gas only leases", then this reading should be clarified either by inserting a comma after "oil and gas leases" or by moving the whole phrase beginning "gas only leases on state land" ahead of "oil and gas leases" and moving the word "or" so it immediately precedes "oil and gas leases" instead of following those words.

C. *15 AAC 55.211(f) — How the 20% GVR is to be "applied separately to ... each lease or property"*.

We are unsure exactly what the Department intends when subsection 211(f) says the GVR "under AS 43.55.160(f) is applied separately to the gross value at the point of production" of oil and gas eligible for the GVR under AS 43.55.160(f)(1), (2) or (3). If it means that the amount of the GVR is *calculated* separately and then the total GVR is subtracted from the GVPP for oil and non-(o)-gas in the North Slope segment, then we have no problem. But if "applied separately" means breaking the North Slope segment up into smaller parts, we believe that would be inconsistent with the segments specified in AS 43.55.160(a)(1)(A) – (G) and AS 43.55.160(a)(2)(A) – (E). We would call attention to the fact that it is because the North Slope (except for (o)-gas) is treated as a single segment that keeps producers from trying to invest preferentially in units or participating areas ("PAs") where they have a greater working interest instead of where their interest is smaller.

D. *15 AAC 55.212 — Issues about the procedures regarding GVRs*.

Subsection 212(a) says a producer may request a determination by the Department literally "[a]t any time" even if the Department is already in the process of making such a determination for the same leases and properties or acreage. The subsection should begin "Unless the department is already in the process of making such a determination for purposes of AS 43.55.160(f) or (g), a producer may at any time request ...."

Subsection 212(b) should say that a determination is subject to change *prospectively* if and when material relevant facts change, and it should say it is subject to retroactive change only to the extent it was made in reliance on a producer's material misrepresentation or failure to disclose a material fact. For this latter purpose, and to avoid redundancy and potential inconsistency, the last two sentences in subsection 212(e) on page 14 should be modified as appropriate and relocated to 212(b).

Subsection 212(c) prescribes procedures for giving notice to other working interest owners in leases and properties in an expansion of an existing participating area and for giving those workinginterest owners an opportunity to be heard. Such notice should also be given to the operator and other working-interest owners when a producer-applicant applies for a determination under 15 AAC 55.212(a)(1), (2) or (3). We recommend putting these notice procedures in a separate subsection of 212, with a declaration that they apply to applications made under 212(a) as well as 212(c).

Subsection 212(d) prescribes procedures regarding the Department's investigation into the facts and circumstances regarding an application for a determination under 212(c) and the methodology to be used for determining the amount of production eligible for the GVR and $5/barrel tax credit for "new" production. Again, such procedures should apply to requests under 212(a) as well.

In addition, since any producer can initiate a request under 212(a) or (c) no matter how small its working interest might be, subsection 212(d) or 212 (e) should provide for giving greater deference or consideration to information presented by an operator, and to a methodology proposed by an operator, because the operator operates the leases and properties on behalf of the working-interest owners collectively and is accountable to them — no one else is better positioned to present their collective interests to the Department, or to explain the practical and technical constraints that may exist that affect the nature and substance of the methodology to be applied.

Subsection 212(e) needs to set a deadline for the Department to issue its written determination, and if it fails to do so by that deadline, the requested determination and methodology should be deemed to be granted as of the date of the deadline. In light of the Department's lack of in house professional expertise and experience and no apparent plan to retain experienced experts to advise it (discussed *infra* at pages 6 – 7 of this Enclosure A), we fear the Department will take an inordinately long time to provide a decision regarding a GVR request. For the GVR and its associated $5/barrel tax credit to succeed as production incentives as the Legislature and the Governor expected, the Department must be ready, willing and able to act in a timely way.

Finally, 15 AAC 55.212 as proposed fails to provide adequate protection of the confidentiality of a producer/taxpayer's materials and information provided to the Department. The explicit protection in 212(d)(2) applies only to applications submitted under subsection 212(c). It is an open question whether confidentiality applies to the request under 212(a), to the Department's written determinations made under 212(e), or to the contents of an appeal by an aggrieved producer pursuant to 212(f). This needs to be clarified.

E. 15 AAC 55.213 — Problems with the proposed "methodologies" applicable to GVRs under AS 43.-55.160(f)(3) for acreage added to an existing participating area.

We acknowledge that AS 43.55.160(f)(3) calls for a "producer [to] demonstrate[ ] to the department that the volume of oil or gas produced [and receiving a GVR under AS 43.55.160(f)(3)] is from acreage added to an existing participating area." It is not possible, however, to send monitors underground to watch the oil and gas moving through the reservoir rock as eyewitnesses to its drainage from the added acreage, nor is it possible to install measuring equipment underground to determine in the reservoir the exact volume that is being so drained. The questions therefore are —first, the degree of certainty that is technologically achievable for demonstrating that production has come from the added acreage instead of other acreage; second, the degree of accuracy that is technologically achievable for determining the volume of the drainage production from the added acreage; and third, whether the ultimate technologically achievable standards for these two factual determinations will be required, or whether something short of that can still reasonably demonstrate and establish these two facts with sufficient reliability.

Subsection 213(a) and (c) reflect an assumption that it is possible to determine with such unachievable precision the volume of oil or gas drained from the added acreage in a participating area and production drained from other acreage. Subsection 213(c) goes on to require that this determination be to an accuracy that allows a producer to show that "no more than one-tenth of one percent of either the oil or gas" measured for the added acreage "consist[s] of oil or gas, respectively, drained from outside the added acreage." We understand the Department's goal, but it is impossible to make a showing to that degree of accuracy.

More fundamentally, how do subsections 213(a) and (c) expect a producer to identify oil or gas drained from the added acreage and distinguish it from oil or gas drained from other acreage? The added acreage almost always will be draining part of the same reservoir that is being drained by the pre-existing acreage in the PA (otherwise DNR probably would not have approved the PA's expansion to include the added acreage[2]). Unless it is a very large reservoir, the geologic processes that generated the oil or gas and caused it to accumulate in the reservoir rock are likely to have been virtually identical for all parts of that reservoir. This means that the natural characteristics of the oil or gas — such as API gravity, hydrocarbon makeup, "signature" impurities — are likely to be indistinguishable from one part of the reservoir to another. Even individual well testing cannot distinguish between oil or gas from one area of the reservoir and oil and gas from a different area of it, much less quantify how much there is of each.

Subsection 213(b) is predicated on the assumption that the wells through which oil or gas is being drained from the added acreage to a PA can be individually metered, and 213(d)(2) and (e)(1) require individual metering on a continuous basis. Again, this is unrealistic. The fluids produced from those wells will likely be a mixture of oil, free gas, dissolved gas, free water, water emulsified with oil, water vapor, sediments or mud from the reservoir, and perhaps other impurities such as carbon dioxide and hydrogen sulfide. It is technologically feasible to measure the gross fluid flow from each individual well and the oil or gas portion of it. But it is expensive to install all those meters, their accuracy depends of whether the water content falls within certain limits, and even within those limits the achievable degree of accuracy is as high as the Department seems to expect — certainly not to meet the "one-tenth of one percent" standard in 213(a) and probably not even the standard of "plus or minus five percent" to "a 90 percent or higher level of confidence" under 213e)(1). Equal or superior accuracy in determining the volumes of oil and gas produced from a well can often be achieved by periodic well tests. Indeed, periodic well tests are what the AOGCC generally allows for determining the reportable volumes of oil, gas and other substances produced from individual wells. *See* 20 AAC 25.230(a).

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2 *See* 11 AAC 83.351(b) and (c).

Initially, subsection 213(f) — in particular, the list of items to be "take[n] into account" in the second sentence of (f) on page 21 —appears to offer a promising alternative to the impracticable and unrealistic methodologies under subsections 213(a) – (e), since it offers the possibility of "demonstrat[ing] ... that the [alternative] methodology is sufficiently reliable and accurate for the purposes of AS 43.55.160(f)(3)." But then, in the last sentence of subsection (f) on page 22, the Department reopens the door to requiring well test frequencies, well testing techniques, and production-allocation methods "different ... than [*sic*[3]] [the ones] required or approved by applicable regulatory agencies" like the AOGCC.

The flaw in the approach taken in 15 AAC 55.211 – 15 AAC 55.213. The great, fundamental flaw in 15 AAC 55.211 – 15 AAC 55.213 as proposed is that they do not build off the technical knowledge, expertise, and tried and true practices of the AOGCC and DNR in particular on the parallel issues that those agencies face regarding allocation of oil, gas, water and other substances from wells back to the respective acreage or leases or properties from which they came. This flaw is mentioned in the letter, and here we present it in more detail.

DNR, acting on behalf of the State as a landowner, has a duty to ensure that production from a unitized field or from a PA within such a unit is properly and accurately allocated to the respective state oil and gas leases within that field or PA — especially if some state leases bear a higher royalty rate than others or have a net profits interest in addition to a royalty, or if the unit or PA contains land that is not state land. This duty flows as a direct logical consequence from the constitutional mandate that "[t]he legislature shall provide for the utilization, development, and conservation of all natural resources belonging to the State, including land and waters, for the maximum benefit of its people." Art. VIII, § 2, Alaska Constitution.

In implementing its statutory authority under AS 38.05.020, 38.05.145 and 38.05.180, DNR has adopted 11 AAC 83.301 – 11 AAC 83.395 regarding the formation of units containing state land and participating areas within those units. In order to approve a proposed unit agreement,[4] a proposed participating area,[5] or "a proposed or revised production or cost allocation formula"[6] when a participating area is expanded or contracted,[7] the commissioner of DNR must make a written finding that it will —

> (1) promote conservation of all natural resources, including all or part of an oil or gas pool, field, or like area;
> (2) promote the prevention of economic and physical waste; and
> (3) provide for the protection of all parties of interest, including the state.[[8]]

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[3] Wm. Strunk Jr. & E. B. White, *The Elements of Style (illustrated)* (Penguin Press: New York 2005), ch. 4 "Words and Expressions Commonly Misused" at 70: "***Different than.*** Here logic supports established usage: one thing differs *from* another, hence, *different from*. Or, *other than, unlike*." (original italics and bold font).

[4] 11 AAC 83.303(a).

[5] 11 AAC 83.303(c)(4): "The commissioner will consider the criteria in (a) and (b) of this section when evaluating ... (4) a participating area[.]"

[6] 11 AAC 83.303(c)(5): "The commissioner will consider the criteria in (a) and (b) of this section when evaluating ... (5) a proposed or revised production or cost allocation formula."

[7] 11 AAC 83.351(c) provides in pertinent part, "A revised ... formula allocating production and costs must be submitted for approval under 11 AAC 83.371 at the time of expansion or contraction of a participating area."

[8] 11 AAC 83.303(a).

In evaluating any such proposal and applying these three criteria, the commissioner is to consider —

> (1) the environmental costs and benefits of unitized exploration or development;
> (2) the geological or engineering characteristics of the potential hydrocarbon accumulation or reservoir ...;
> (3) prior exploration activities in the proposed ... area;
> (4) the applicant's plans for exploration or development of the ... area;
> (5) the economic costs and benefits to the state; and
> (6) any other relevant factors, including measures to mitigate impacts identified above, [which] the commissioner determine necessary or advisable to protect the public interest.[9]

From these regulations it is clear that, for any proposed expansion of a PA — which is what AS 43.55.160(f)(3) applies to — the DNR commissioner will not approve it unless the allocation of production and costs to the added acreage "protect[s] all parties of interest, including the state." Thus, since those interests are already being protected by DNR, we see no reason for the Department to try to re-protect those same interests through a regulation like 15 AAC 55.213. At best nothing additional will be achieved by the regulation, and at worst it could contradict or conflict with what DNR is doing. Moreover, the Legislature in enacting AS 43.55.160(f)(3) seems to be specifically aware of these responsibilities and duties of DNR, since it refers to "acreage that was added to an existing participating area <u>by the Department of Natural Resources</u>" (emphasis added). There was no need or occasion to refer specifically to DNR in this way unless the Legislature wanted to refer indirectly to this role that DNR already plays in "protect[ing] all parties of interest, including the state."

We believe, therefore, that 15 AAC 55.211 – 15 AAC 55.213 could, and should, be materially improved and drastically shortened and clarified by simply saying that — for units, PAs and other acreage involving state lands — the production subject to a GVR and the $5/barrel tax credit under AS 43.55.160(f) and (g) is to be determined by applying the factors that DNR has approved for allocating production to specific acreage or leases or properties within such a unit or PA.

It seems possible, however, that lands beneath the beds of navigable waters within National Petroleum Reserve – Alaska ("NPR-A") and within other federal reserves in existence at Statehood are federal lands, not state lands, under the reasoning of *United States v. Alaska*, 423 F.2d 764 (9th Cir.), *cert. denied*, 400 U.S. 967, 91 S.Ct. 363, 27 L.Ed.2d 388 (1970) because they, like the lands in the Kenai National Moose Range, were reserved by the federal government at Statehood and title to them therefore did not pass to the State under the Submerged Lands Act (Pub.L. 83-31, 67 Stat. 29) as made applicable to Alaska by § 6(m) of the Alaska Statehood Act (Pub.L. 85-508, 72 State. 339).[10] If lands beneath navigable waters in NPR-A are federal lands, then units and participating areas formed within NPR-A would not be subject to approval by DNR acting on behalf of the State as a landowner, but they would remain subject to regulation by the AOGCC through its exercise of the State's sovereign Police Power unless there were a further preemption of the State from exercising that Power within a specific federal reserve.[11] Therefore, if the submerged lands within

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9 11 AAC 83.303(b).

10 We present this discussion merely is a possibility for the Department to consider, not as a view held by AOGA or any of its members. The Department should seek advice from the Department of Law about any questions of state or federal ownership of lands beneath navigable waters within NPR-A or any similar pre-Statehood federal reserve.

11 Section 10(c) of the Statehood Act provides for such a preemption of the State's sovereign powers within any "special national defense withdrawals" created pursuant to § 10(a) of that Act. We are aware of no such "special national defense

NPR-A are indeed federal lands, then the Department should add a provision in its SB 21 regulations for the use of allocation formulas that the AOGCC has approved in the exercise of its Police Powers to protect correlative rights and prevent physical waste of oil and gas resources, since such an AOGCC approval should have full force and effect within NPR-A and other pre-Statehood federal reserves unless there has been a further preemption of the State's powers within a specific reserve.

The Department lacks the necessary professional expertise and experience in house to be able to establish or apply the technical standards and criteria contemplated in 15 AAC 55.213, nor does it have any current plan or intention to obtain such expertise and experience from a contractor. The Governor's Amended Budget for the current Fiscal Year (2014) shows 124 authorized permanent full-time positions in the Tax Division, plus one permanent part-time position and one non-permanent position.[12]

In reviewing the job titles and classifications for these positions, no one in the Tax Division has any professional background or experience with the physical and chemical engineering and other technical sciences that are applicable to oil and gas drainage and recovery from a reservoir, operations on the surface to separate oil, gas, connate water, other substances and impurities that are in the raw fluids flowing up through the individual wells, and the technology and physical methods for measuring the quantities or volumes of those fluids and their oil, gas and other physical components. Yet, despite the fact that the Department lacks the necessary technical knowledge and experience in house, it appears it has no intention to hire a qualified contractor to secure that knowledge and experience by the fact that the "Additional Regulations Notice Information (AS 44.62.190(d))"[13] issued 19 July 2013 in conjunction with these proposed regulations shows the Department's *total* "Cost of implementation" for the proposed regulation to be ZERO for FY 2014 and subsequent fiscal years. If the Department does plan to increase technical staff to implement SB 21, we would expect a supplemental appropriation request to be submitted.

<u>The need to provide an opt out for potential "new" production</u>. We are concerned about what a producer's options will be if it has oil or gas production that could qualify for a GVR under AS 43.55.160(f), but it doesn't want to undergo the hassle and possibly inordinate expense in the measuring equipment and other items that will be required in order to satisfy the Department that the terms and conditions required under proposed 15 AAC 55.211 – 15 AAC 55.213 are fulfilled. In other words, suppose the costs to set up an allocation methodology that the Department would approve under these regulations are not economically justifiable, even for a 20% or 30% GVR and the associated $5/barrel tax credit. Can the producer treat this production as "legacy" production for purposes of the stair stepped per barrel tax credit under AS 43.55.024(j)? Or will that production be stuck in a "no man's land" where it is neither "new" nor "legacy"?

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withdrawal" now in existence. We have not looked for any other federal statutes that might preempt Alaska's sovereign powers.

12 Source: http://omb.alaska.gov/ombfiles/14_budget/Rev/Proposed/2476%20-%20Tax%20Division.pdf (downloaded 19 August 2013).

13 AS 44.62.190(d) provides: "Along with a notice [of the proposed adoption, repeal or amendment of regulations] furnished under (a)(2), (4)(A), or (6) of this section, the state agency shall include the reason for the proposed action, the initial cost to the state agency of implementation, the estimated annual costs to the state agency of implementation, the name of the contact person for the state agency, and the original of the proposed action."

Since the Legislature has chosen to provide an incentive to increase production from "legacy" leases and properties, we see no reason why potentially "new" production should not be allowed "legacy" treatment if that is what the producer wants instead of "new" treatment under AS 43.55.160(f) and (g) and AS 43.55.024(i). Certainly there is nothing in SB 21 requiring that otherwise "new" production be denied "legacy" treatment if the producers of that production voluntarily opt for that treatment. And we think it would be contrary to the Legislature's expectations and intent if the Department were to deny the "legacy" incentive by regulation.

Accordingly, we recommend that, if the Department decides to adopt 15 AAC 55.211 – 15 AAC 55.213 substantially as proposed, then it should adopt the following new subsection at the end 15 AAC 55.211:

> (g) If a producer has oil or gas production from acreage or a lease or property that would qualify to receive a 20 percent reduction under AS 43.55.160(f) as interpreted and applied by this section if the producer fulfilled the applicable conditions and requirements under 15 AAC 55.212 and 15 AAC 55.213 for that production, but the producer does not fulfill those conditions and requirements, then AS 43.55.160(f) and (g) do not apply, and AS 43.55.024(j) does apply, to that production until such time as the producer fulfills the applicable conditions and requirements under 15 AAC 55.212 and 15 AAC 55.213 for that production, at which time
>
> (1) that production will begin to receive the applicable reduction under AS 43.55.160(f) and (g), and
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> (2) AS 43.55.024(i) will commence to apply instead of AS 43.55.024(j) to that production.

<u>Incentives for "legacy" production — the Department's failure to propose a necessary regulation</u>. AS 43.55.150(b) says "the gross value at the point of production is calculated using the actual costs ... or the reasonable costs of transportation ..., whichever is lower" if a producer ships oil through an affiliated pipeline company. For purposes of determining the GVPP as an intermediate value in the calculation of the PTV on which the tax is based, the Department has adopted 15 AAC 55.193(c)(5) declaring that, except in specific limited situations, "reasonable costs" for pipeline transportation are "103 percent of the costs of transportation <u>calculated by the department</u> [for that pipeline] ... under 15 AAC 55.197" (emphasis added). Neither of these regulations sets a deadline for the Department to make its calculation under 15 AAC 55.197 and inform a producer what that calculated cost is. Certainly, it is not before the end of the calendar month after the production month for the oil so transported, which is the due date for reporting and paying the monthly installment payment under AS 43.55.020(a).

Under these regulations there is only a limited time when regulated pipeline tariffs "adjudicated" by FERC or the RCA to be "just and reasonable" or "accepted" pursuant to a settlement to which the State is a party will be recognized under 15 AAC 55.193(e) – (i) as the "reasonable" cost for that transportation.

An "adjudicated" tariff is recognized only for the first "five years after the end of the test period on which the tariff rate is based".[14] A settlement tariff determined by a "cost based tariff settlement methodology" is also recognized only for five years unless the settlement provides for a redetermination of the tariff calculation every three years after the initial five-year period, in which case the tariff under that methodology is recognized for three years after each such redetermination.[15]

In either case, 15 AAC 55.193(h) provides that 103% of the Department's determination under 15 AAC 55.197 — instead of the tariff allowed by FERC or the RCA and which the producer/shipper actually pays, — will be the "reasonable" cost whenever "a protest or complaint has been filed with and accepted for investigation" by FERC or the RCA. Further, no deadline is set for the Department to make its determination under 15 AAC 55.197 in any of these circumstances, so a tariff that is actually paid by a producer can be superseded by the Department's imputed tariff under § 197 but the producer won't know how much that § 197 tariff is until as much as six years later under the statute of limitations in AS 43.55.075(a).

This approach, if reformed, might be appropriate for purposes of determining the taxable PTV on which the tax under AS 43.55.011(e) is calculated, because there are lot of upstream costs and downstream costs that flow into that PTV. But it certainly is not appropriate for determining a producer's GVPP per barrel that in turn determines the amount of the stair stepped per barrel tax credit that is applicable to that producer's "legacy" production under AS 43.55.024(j)(1) – (9). As noted in the letter of which this Enclosure A is a part, the producer needs to know how much its monthly Section 024(j) credit is when it reports and pays its installment payment under AS 43.55.020(a) for its "legacy" oil at the end of the month after the one when that oil was produced. Whenever the GVPP per barrel for a given month ends up being somewhat close to the ceiling value for a given step in the tax credit, applying a lower pipeline cost under 15 AAC 55.197 will increase the GVPP and could put the producer into the next higher stair-step, where the tax credit is always $1.00 a barrel less than the one for the lower GVPP stair step.

To allow for the effectiveness of the stair stepped per barrel tax credit under AS 43.55.024(j), the Department should adopt a regulation to limit 15 AAC 55.193(e) – (i) and 15 AAC 55.197 so they apply only to the determination of taxable PTV, and not to the determination of GVPP for purposes of determining the amount of the tax credit under AS 43.55.024(j).

We recommend adding the following subsection (t) to 15 AAC 55.193and re-lettering the present subsection (t) as (u):

> (t) In computing the gross value at the point of production per barrel of a producer's taxable production for the purpose of determining the amount of a tax credit under AS 43.55.024(j) for that production, the cost of transportation of the production by a regulated carrier is the actual cost for that transportation under (b)(1) of this section without regard to any retroactive change to or refund of the regulated tariff that is, after the end of the calendar month after the respective month when the oil or gas is produced, ordered by the Regulatory Commission of Alaska or another regulatory agency having jurisdiction; and no other provisions of this section and 15 AAC 55.197 that would otherwise be applicable to the cost of that transportation by the respective regulated carrier may be applied in determining the amount of the tax credit under AS 43.55.024(j) for that production.

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[14] 15 AAC 55.193(e).

[15] 15 AAC 55.193(g).

PART 2. TRULY TECHNICAL MATTERS

<u>Certain drafting conventions make the regulations unnecessarily difficult to read and comprehend</u>. AOGA wishes to point out that the proposed regulations' stylistic drafting convention of inserting, between a pair of commas to set the insertion off, an illustrative or ancillary passage comprised of a series of terms that themselves are separated by commas — for example, the new text being added to 15 AAC 55.206(c)(2)(B) on page 4 — creates significant and unnecessary difficulty for readers trying to follow the grammatical and logical structure of the regulation. If the new multi-comma passage to be inserted cannot be located elsewhere within a regulation to provide clarity, then the Department should consider using pairs of em-quad hyphens to set the passage off in order to make it clear to readers where the logical flow and structure of the regulation are being interrupted for that passage and where they resume at the end of it. There are a number of places in the proposed regulations where this drafting convention has been followed.

A second drafting convention creates different, but potentially equal difficulty in comprehending what has been written. This is the practice of including in an introductory phrase certain words that are intended to modify or apply to the first word or phrase in each of the subparts that follow. An example will illustrate this problem.

15 AAC 55.211(b) begins as follows:

> (b) For purposes of AS 43.55.160(f)(1) and 43.55.160(g), a lease that includes land that was within a unit on January 1, 2003, is not considered to be a lease that was within that unit on January 1, 2003, if the lease
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> (1) was issued following the expiration of a former lease containing the land, the lease was not within that unit at or after the time the lease was issued, and in the case of a state lease the lease was assigned an Alaska Division of Lands (ADL) number different from that of the former lease by the Department of Natural Resources; or
>
> (2) was segregated from an existing lease into a separate and distinct lease comprising a portion of the land that was formerly within the existing lease, the lease was not within that unit after it was segregated, and in the case of a state lease the lease was assigned an Alaska Division of Lands (ADL) number different from that of the existing lease by the Department of Natural Resources.

Here, the words "if the lease" at the end of the introduction are intended to be the subject of the respective verbs "was issued" and "was segregated" in paragraphs (1) and (2). The problem is, within each paragraph there is a series of phrases that are themselves parallel. In paragraph (1) these parallel phrases are "[the lease] was issued ...", "the lease was not within that unit ...", and "the lease was assigned" a different ADL number, with the subject of the first verb being in the introduction instead of at the beginning of the paragraph. Ditto for paragraph (2).

The unexpected appearance of the same subject — "the lease" — in the second and third phrases that the reader understands to be implied in the first phrase in the paragraph causes confusion because the parallel logical structure that the reader initially saw vis-á-vis the introduction and paragraphs (1) and (2) now appears to be violated within each paragraph, and a reader who is not a grammarian by vocation or avocation may be hard put to reread the section and put the logic back together correctly.

Such difficulty is a common artifact of this drafting convention where a subject — or, worse, a fragment comprised of one or more modifiers (usually adjectives or adverbs) that are intended to modify each subject or verb in a series of parallel subparts — is placed at the end of an introductory text. While we agree with the idea of avoiding unnecessary repetition, comprehensibility must not be sacrificed on the altar of verbal parsimony. In the case of 211(b), significant clarity would be achieved by adding the two words "the lease" at the beginnings of paragraphs (1) and (2) and deleting them at the end of the introduction. The net increase in word count is only two.

As it turns out in this particular example, the text within paragraphs (1) and (2) violates the very same drafting principle of avoiding needless repetition of a subject that is common to a series of verbs. In other words, removing "the lease" at the beginning of the second and third clauses in each paragraph would have made them shorter, made them parallel with the overarching grammatical structure of the subsection, and made the subsection more readily comprehended; *viz.* —

> (b) For purposes of AS 43.55.160(f)(1) and 43.55.160(g), a lease that includes land that was within a unit on January 1, 2003, is not considered to be a lease that was within that unit on January 1, 2003, if the lease
>
> (1) was issued following the expiration of a former lease containing the land, was not within that unit at or after the time the lease was issued, and in the case of a state lease, was assigned an Alaska Division of Lands (ADL) number different from that of the former lease by the Department of Natural Resources; or
>
> (2) was segregated from an existing lease into a separate and distinct lease comprising a portion of the land that was formerly within the existing lease, was not within that unit after it was segregated, and in the case of a state lease, was assigned an Alaska Division of Lands (ADL) number different from that of the existing lease by the Department of Natural Resources.

There is a fair bit of work that should be done to make the regulations clearer and more readily comprehended by future readers who will not have the advantage of having seen now how the proposed changes fit into the existing context for them.

<u>Proposed amendment to the 15 AAC 55 chapter heading (p. 2)</u>. There are *two* oil surcharges in AS 43.-55, not one: the suspendable $0.01 per barrel surcharge levied by AS 43.55.201 and the always applicable $0.04 per barrel surcharge levied by AS 43.55.300. The use of the singular word "Surcharge" in the current statutory chapter heading for AS 43.55 dates back to 1989, when the Legislature enacted a single nickel a barrel surcharge that was levied under former AS 43.55.200. *See* § 2 ch 112 SLA 1989. That surcharge was divided into two parts by §§ 13 – 17 ch 128 SLA 1994. However, presumably because chapter headings are not part of the substantive statutory law of Alaska, the Legislature did not then, and has not afterward, bothered to update the heading for AS 43.55 to reflect that there have been two surcharges starting in 1994. The fact that the chapter heading for AS 43.55 archaically uses the singular word "Surcharge" does not mean the corresponding chapter heading for 15 AAC 55 should contrafactually do so.

<u>Proposed 15 AAC 55.211 – 15 AAC 55.213</u>. We have not attempted to rewrite any of these three regulations to reflect our non-technical comments made elsewhere about them because, without any expression by the Department about how it might be willing to change the substance of these regulations in response to those comments, it would be speculative to draft what we expect the Department's substantive changes might be.

Proposed 15 AAC 55.211(b) (p. 8). When paragraph (b)(1) speaks of

> ... a lease [that]
> (1) was issued following the expiration of a former lease containing the land, the lease was not within that unit at or after the time the lease was issued .... [emphasis added]

the emphasized phrase "the lease was not within that unit at or after the time the lease was issued" is ambiguous. Does the second "the lease" in that phrase refer to the lease "issued following the expiration of a former lease" or to that "former lease"? We believe the first meaning is intended, and if so we suggest replacing that phrase with "the lease at or after the time it was issued was not within that unit".[16] In order to keep (b)(2) parallel with (b)(1) as so changed, we further recommend replacing "that lease was not within that unit after it was segregated" with "the lease after it was segregated was not within that unit" even though (b)(2) is not ambiguous.

Also, with respect to paragraphs (1) and (2) of subsection 211(b), why is it necessary for a new ADL number to have been given to the lease if the first two conditions in (b)(1) or (b)(2) are already met? We understand that DNR's practice is to issue a new ADL number to the portion of a lease that is segregated from the rest of an existing lease. But what if DNR for whatever reason didn't do so in a particular instance when it should have? Why should that error or omission disqualify a lease if it can be proven that the lease meets the first two conditions? The ADL number condition is unnecessary.

Proposed 15 AAC 55.211(d) (p. 9). We have three comments on 211(d), one technical and two substantive. The technical one is that the insertion of the word "and" at the end of 211(b)(3) would make it clear that the substance of paragraphs 211(b)(1) – (4) is not given as alternatives to one another, but those paragraphs are each and all applicable for purposes of AS 43.55.160(f)(3).

Both technical comments concern the use of "if and only if" in the third line[17] of paragraph (1). First, does it pertain only to the clause that "the volume of the oil or gas produced is from that acreage", or does it also pertain to the clause about oil or gas being "produced from acreage added to an existing participating area"? We can't tell.

The second is about the need for using "and only if" there. When "oil or gas is drained from that acreage and is produced within the meaning of AS 43.55.020(e) and 15 AAC 55.151(e)," is there any possible circumstance where that oil or gas would not be considered to have been "produced from acreage added to an existing participating area and the volume of the oil or gas [is considered to have been] produced from that acreage"? We can't think of such an exception. But if the Department has thought of one (or more) exceptions, then the regulation would be more informative and useful if it used only "if" instead of "if and only if" and then — after the word "acreage" at the end of the paragraph, —added a clause that starts ", unless" and then describes the exception(s) that the Department has identified. And if the Department hasn't thought of any exception either, the words "and only if" are surplusage, add nothing of substance, and should be deleted.

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[16] This proposal assumes the Department, in response to our comments above at p. 10 regarding subsection 211(b), takes the first of our two recommendations there and takes the words "the lease" from the introduction and puts them at the beginning of each paragraph.

[17] All references herein to line numbers of a section, subsection, paragraph or subparagraph are to the respective line in that section, subsection, paragraph or subparagraph as it appears in the PDF version of the 46-page set of proposed regulations that was attached to the e-mailed notice dated 19 July 2013 from the Department.

<u>Proposed 15 AAC 55.211(e) (pp. 9 – 10)</u>. We have two questions and one comment here. First, what is a “gas only lease”? The last line on page 9 speaks of “a unit made up solely of oil and gas leases or gas only leases”. We understand the term “oil and gas leases” in its ordinary meaning, but we are unfamiliar with the term “gas only lease”. Rather than speculate what the Department means by this term, it should be defined in 15 AAC 55.900. Second, why can’t there also be “oil only leases”?

Our comment is that the phrase “produced from a unit made up solely of oil and gas leases or gas only leases on state land issued by the Department of Natural Resources” presents three problems. First, the use of disjunctive word “or” between “oil and gas leases” and “gas only leases” implies that a “unit” of the type being referred to must be comprised entirely of “oil and gas leases” or entirely of “gas only leases”, but cannot include leases of both kinds. We doubt this literal reading is intended, and if so, something has to be changed — probably just swapping out the “or” for an “and” will work, but that may depend on what a “gas only lease” is. Second, it is not clear whether the words “on state land” apply only to their closest antecedent — “gas only leases” — or apply also to “oil and gas leases”. If it applies to both, then there is no need to refer to “oil and gas leases” and “gas only leases” at all, since a “unit made up solely of state land” would cover both categories — unless we are mistaken in thinking that the “or” was not intended to preclude a unit comprised solely of a mixture of “oil and gas leases” and “gas only leases”. Third, whatever it is that’s “on state land”, the words “issued by the Department of Natural Resources” are redundant and unnecessary because, under AS 38.05, only DNR can lease state land for oil and gas purposes.

<u>Proposed 15 AAC 55.212(a) (p. 11)</u>. There is a typographical error at the end of the antepenultimate line in 212(a)(2): “AS 43.55.180(p)” should be “AS 38.05.180(p)”. In paragraph 212(a)(3) we again find the term “gas only leases” being used, and our earlier comments about this term apply here as well. The omission of any conjunction at the end of paragraph (2) is inappropriate because a producer will be requesting the Department’s determination for only one of the three purposes in any given submission, unless the Department wants a single submission to request all three kinds of determination. If the latter is intended, the second line in the introduction should be amended after the comma to say “a producer must submit a comprehensive request in writing for the department’s determination for purposes of”; and the word “and” should be inserted at the end of paragraph 212(a)(2) after the semicolon; but if the latter is not intended, then the only change is to insert the word “or” at the end of paragraph (2) after the semicolon.

<u>Proposed 15 AAC 55.212(g) (p. 14)</u>. The subject matter or content of the limiting phrase “, until no oil or gas is produced from the added acreage,” in the last sentence of subsection 212(g) is unrelated to that of the language immediately preceding or following it, and thus it awkwardly and confusingly disrupts the flow of the primary thought (which is complex) being expressed in that sentence. We recommend relocating that phrase so it is between the words “shall” and “use” near the end of the sixth line in the subsection, which is what the phrase is actually modifying and where its disruption of the primary thought is therefore minimized.

<u>Proposed 15 AAC 55.213(a) (pp. 15-16)</u>. The “(a)” at the beginning of the subsection is in bold font and shouldn’t be. The phrase “the purposes” in the third line should be “the purpose” because only one purpose is identified.

Proposed 15 AAC 55.213(c) (pp. 17-18). The phrase "and other information and analysis that the department considers necessary or appropriate for the purposes of AS 43.55.160(f)(3)" at the end of the sentence that ends in the penultimate line on page 17 is so vague, ambiguous and overly subjective as to have no real substance. It would be better to say, "and other information and analysis reasonably requested by the department with respect to the demonstration required under this subsection for the sub-methodology." At least reasonableness has some degree of objectivity to it in the case of any disagreement with the Department about what the producer has to provide under this subsection.

Proposed 15 AAC 55.213(d) (p. 18). The four paragraphs of subsection 213(d) express four conditions that will all exist once "a methodology subject to this subsection" is approved by the Department. Therefore, the word "and" should be inserted after the semicolon at the end of paragraph 213(d)(3).

Proposed 15 AAC 55.213(f) (pp. 21-22). The comments above regarding the phrase "and other information and analysis that the department considers necessary or appropriate for the purposes of AS 43.-55.160(f)(3)" that appears in subsection.213(c) apply equally to this phrase when it appears in subsection 213(f) in the last two lines on page 21 and carrying over to the first line on page 22.

Proposed 15 AAC 55.215(g) (p. 27). Subsection 215(g) appears to be an instruction to the producer or a requirement to be met by the producer with respect to the allocation of lease expenditures that 215(g) addresses. If so, then the verb "is allocated" in the fourth line — which expresses merely a state of being allocated, not a direction to make that allocation — should be replaced by "must be allocated".

Proposed 15 AAC 55.335(d)(1) (p. 33). First regarding the word "calculating" at the beginning of paragraph 335(d)(1), does one "calculate" the number of the barrels being described in that paragraph, or does one "determine" that number? Since the context of paragraphs 335(d)(1) – (3) is the calculation contemplated in the introduction to subsection 335(d), perhaps "determining" is the better word to use at the beginning of 335 (d)(1).

Second, the criteria in AS 43.55.160(g) are necessary and sufficient for determining that the oil or gas is "new" production to which the stair stepped per barrel tax credit under AS 43.55.024(j) does not apply. AS 43.55.160(j) adds only the further condition that all the royalty on that "new" production must be greater than 12.5 percent in order to get the additional 10% GVR — it does not bear on the issue of whether the production is "new" or not. Accordingly, the "or (g)" immediately before the semicolon at the end of paragraph 335(d)(1) is inappropriate and unnecessary, and it should be deleted.

Third, consistent with our concern about ensuring that production that a producer does not choose to qualify as "new" oil under 15 AAC 55.211 – 15 AAC 55.213 will then be treated as "legacy" production instead of falling into a no man's land, we propose inserting between "does not meet" and "any" in the third line of paragraph 335(d)(1) the following: ", or is not reported as meeting,".

Proposed 15 AAC 55.335(e)(1) (p. 34). The clause "the gross value at the point of production is not reduced under AS 43.55.160(f) or (g)" at the end of paragraph 335(e)(1) is similar to the one in 15 AAC 55.214(g) that we commented on — it, too, expresses merely a state of being (i.e., not being reduced) rather than being an instruction to not make such a reduction. To make it an instruction, we recommend inserting "for purposes of this paragraph," between the first semicolon and "the gross value".

<u>Proposed 15 AAC 55.335(g) (p. 35)</u>. There is a typographical error in the second line of subsection 335(g). The reference to “15 AAC 55.212(f)” should be to “15 AAC 55.212(g)” instead.

This concludes AOGA’s technical comments regarding the proposed regulations. We again express our pleasure to have this opportunity to share our views about them with the Department.